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IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1964

No. 326

ARTHUR W. SLOAN, FRANKLIN C. SALISBURY, AND ATLANTIC RESEARCH CORPORATION,
Petitioners,

v.

SAMUEL MELTZER, *Respondent*

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

REPLY TO RESPONDENT'S BRIEF

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INDEX

Table of Authorities

Cases:

	Page
Levitt v. *Johnson*, CCH Fed. Sec. Law Reporter, Sec. 91413, P. 94641 (6 Cir., Op. No. 6249, July 8, 1964, not yet officially reported)	4
Smith v. *Sperling*, 354 U.S. 91	5
Swanson v. *Traer*, 354 U.S. 114	5

Statutes and Regulations:

Federal Rules of Civil Procedure—Rule 23(b)	3, 3, 4, 4, 5, 5, 6, 6, 6, 7

Administrative Decisions:

Matter of Atlantic Research Corporation (SEC, Dec. 6, 1963, Securities Act Release No. 4657)	1, 2, 3

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Respondent relies on the opinion of the Securities and Exchange Commission (SEC) in *Matter of Atlantic Research Corporation* (Dec. 6, 1963, Securities Act Release No. 4657) in support of his position. It should be noted that the SEC opinion was based upon an *ex parte* "private investigation"— a one-sided record with no opportunity to Atlantic to know what was in the record, to cross examine witnesses or to submit rebuttal evidence.

The SEC opinion was issued approximately twelve months after the filing of the amended complaint. Those findings, though issued in December, 1963, pertain to a

registration statement for 179,000 shares of Atlantic's 2,000,000 issued shares, and generally are addressed to facts existing in July, 1962 and prior to that date—not to facts existing after the SEC began its investigation in August of 1962. The SEC made no finding that all of the Board members were wrongdoers in support of Respondent's contention that a demand on the Board would therefore be futile. The SEC confined its opinion to the alleged wrongdoings of Petitioner, Scurlock. It did not criticize Sloan or the other Board members named by Respondent in his complaint.

As was pointed out in the Petition for Certiorari of Petitioners Sloan, Salisbury and Atlantic, ("Sloan Petition"), Dr. Scurlock was removed in 1962 from his position as President and Chief Executive Officer of the Corporation. (SEC Opinion, page 6.) Dr. Scurlock is not now President of Atlantic as alleged by Respondent in his complaint and brief. (Respondent's Brief, page 3.) Furthermore, the five Petitioners (Scurlock, Sloan, Johnston, Salisbury and Schoeffel) do not now constitute the entire Board of Directors. (Respondent's Brief, page 3.) Two new outside directors were elected (Sloan Petition, Appendix F, page 60) contrary to Respondent's assertion that the Board "failed to appoint any new directors." (Respondent's Brief, page 5.)

It should also be pointed out that the $3,900,000 figure which Respondent alleges was divested from Atlantic by Dr. Scurlock is not found anywhere in the SEC Opinion. The SEC found in its Opinion after the "private investigation", that ARC loaned Pine Ridge Corporation a total of $556,937 (SEC Opinion, page 9) and Texas Capital Investments, Inc., a total of $1,215,000 (SEC Opinion, page 15).

Respondent also implies that the guarantee of Petitioners, Sloan and Scurlock is questionable because "the financial responsibility of these two individuals is highly doubtful". (Respondent's Brief, page 6). The reserve set up against the loans referred to by Respondent in his brief (page 6) was eliminated after Drs. Scurlock and Sloan reaffirmed the guarantee. (SEC Opinion, page 17). This fact disproves this claim of Respondent.

Without pointing out all the other erroneous statements made by Respondent in his brief and complaint, Petitioners urge that the mistakes of fact cited prove the wisdom of Rule 23(b). They prove the value of that Rule's requirement that a stockholder go to the Board of Directors for corrective action before coming into court. If Respondent went to that Board as the District Court required, he would soon know of these and other errors of fact and perhaps find that the Board, as suggested by the District Court, had taken all the corrective action he seeks. (Sloan's Petition, Appendix B, page 40).

Petitioners reiterate again that this case was not decided merely on the allegations in the complaint. As the record shows, extensive depositions—ignored by the Court of Appeals—prove conclusively that Respondent did not even consider compliance with Rule 23(b) in his rush to file his original complaint.

Contrary to Respondent's contention that state law determines whether a demand must be made on a board of directors prior to bringing a derivative action, (Respondent's Brief, pages 7-9) the Fourth Circuit declared in its decision:

> "The necessity and sufficiency of the preliminary demand upon the directors, and the circumstances which

> satisfies omission of such demand, under Rule 23(b) would seem to be procedural in nature and hence governed by Federal law. (citations omitted) (Sloan Petition, Appendix A, page 24).

The Fourth Circuit merely declared that "Virginia decisional law appears to be in accord." (Sloan Petition, Appendix A, page 24).

Respondent cites cases which merely emphasize the conflict and confusion which exists over Rule 23(b) due to the Fourth Circuit's opinion. Respondent cites the case of *Levitt* v. *Johnson*, CCH Fed. Sec. Law Reporter, Sec. 91413, p. 94641-2 (Cir. 1, Op. No. 6249, July 8, 1964, not yet otherwise reported) in support of his contention that a demand on the Board of Directors was excusable (Respondent's Brief, page 10). It should be noted, however, that the question before the Court in *Levitt* was not whether a preliminary demand should have been made upon the Board of Directors, but rather *should a demand have been made upon the stockholders* before bringing a derivative action. Clearly, the two demands are vastly different, as sending a demand for corrective action to thousands of stockholders is more difficult than sending it to seven directors. The Court's holding that a demand upon *the stockholders* would have been burdensome and therefore not required makes the conflict among the circuits on this issue more apparent. (See Sloan Petition, page 18). The need for clarification of Rule 23(b) by this Court is all the more urgent. The First Circuit in *Levitt* did hold as did the Fourth Circuit in the case at bar that state law does not govern the adequacy of an excuse for failure to make a demand for corrective action on the

Board of Directors or stockholders. This is directly contrary to Respondent's contention. (Respondent's Brief, pages 7-9).

Respondent relies on the companion cases of *Swanson* v. *Traer*, 354 U.S. 114 and *Smith* v. *Sperling*, 354 U.S. 91 in further support of his argument. It should be noted, however, that in *Swanson*, the question before this Court was solely Federal diversity jurisdiction and the proper alignment of parties to a derivative action. In *Sperling*, this Court was also confronted with the question of proper alignment of parties. Unlike the case at bar, in *Sperling*, a demand had been made on the Board of Directors and was refused. This Court held, therefore, that the corporation was properly made a defendant. In neither of these cases was this Court confronted with the issue raised by Petitioners here—the proper interpretation and effectiveness of Rule 23(b).

Almost two years have elapsed since the filing of the original complaint in November, 1962. It is obvious that in two years many things are bound to have happened which are all the more reason to require Respondent to make his demand for corrective action upon Atlantic's Board of Directors. Changes that have occurred within Atlantic since the filing of the original complaint could well satisfy any demand he may wish to make and render resort to court action unnecessary—the very purpose of Rule 23(b).

That the purpose of the Rule was to provide a remedy before the agency best equipped by information, experience and power to take appropriate action to cure stockholder complaints, cannot be denied. The avoidance of court trials of corporate matters where directors could straighten them

out to stockholder satisfaction, and thus avoid litigation, is a purpose this Court should not allow to be frustrated. It is preposterous to assume that after two years, during which it is obvious that two stockholders' meetings and many Board meetings have been held, nothing has been done about the problems mentioned in the complaint. It would do violence to the text, as well as the purpose, of Rule 23(b) to force the District Court, instead of the Directors, to act in this case—the very type of case which the Rule was intended to cover.

Respondent has made some shocking allegations against Petitioners and at this stage of this lawsuit Petitioner cannot refute them because in testing the complaint under our jurisprudence they must be assumed to be true. But, Rule 23(b) does not say it is applicable only to "good" men and inapplicable to "bad" men. It applies to all men. It says in plain language that the administrative remedy there provided must be exhausted before a stockholder can bring his complaint into court. Respondent did not exhaust his administrative remedy—he ignored it. His complaint must be dismissed or the Rule becomes worthless because under the Fourth Circuit's decision any stockholder who makes his allegations shocking enough, and accuses the entire membership of a Board of Directors of wrongdoing, can get into a court without going to the Board of Directors first.

It is overwhelmingly evident under all the facts and circumstances as to potential stockholder litigation, that this is a case of national importance which should be reviewed and reversed by this Court. The Fourth Circuit's decision will at best allow every stockholder with an uncontrollable option to nullify the effectiveness of Rule 23(b). Clearly, the Federal courts will be flooded by the

very stockholder litigation which Rule 23(b) was intended to prevent.

Respectfully submitted,

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